Computer Programming Can Be Used to More Effectively Stop Refunds on Illegal Claims for Reparations Credits

March 2002

Reference Number: 2002-30-071

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 28, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: Pamela J. Gardiner
                        Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Computer Programming Can Be Used to
                        More Effectively Stop Refunds on Illegal Claims for Reparations
                        Credits (Audit # 200130028)

This report presents the results of our review of the Internal Revenue Service's (IRS) procedures and criteria to identify claims for reparations credits and stop the associated refunds. Our objectives for this review were to assess current controls over these claims, determine if a computer program could be used to strengthen controls, and determine whether IRS employees were involved in claiming or allowing these claims.

Since the early 1990s, thousands of taxpayers have filed specious tax claims with the IRS for reparations credits payable to descendants of slaves. The Internal Revenue Code[1] does not provide for, or allow, such a credit. As a result, the IRS tries to identify tax returns containing these claims, deny the claims, and stop any resulting refunds before they are issued to taxpayers. The vast majority of these claims are manually identified by IRS employees before any data are input to the IRS' computer systems.

Because the manual screening of tax returns by IRS employees is subject to human error, and because some employees may knowingly allow these illegal claims to be processed, some claims for reparations credits are processed and refunds sent to taxpayers. Early in Calendar Year 2001, the IRS found that this was occurring more often. Many taxpayers claiming reparations credits had received refunds, some of which exceeded $80,000 for married taxpayers claiming reparations credits for each spouse. As a result, management from the IRS' Frivolous Return Program asked the Treasury Inspector General for Tax Administration (TIGTA) to help improve IRS controls by developing a computer program to identify tax returns being processed that

---

[1] Internal Revenue Code, 26 U.S.C. (1994 & Supp. IV 1998).

contained claims for reparations credits. The TIGTA agreed to try and develop this computer program and to initiate an audit to review IRS controls related to these claims.

In summary, controls designed by the IRS to identify and stop claims for reparations credits from refunding, once the claims were entered into IRS computers, could be significantly improved by using a TIGTA-developed computer program. We estimate that, using this program, IRS employees could identify 91 percent more of these returns than they could using the existing processes.

Further, we identified one current and eight former IRS employees who claimed reparations credits on their own tax returns. In addition, we identified one employee who may have knowingly honored a claim made by another taxpayer. Pertinent information has been referred to the TIGTA Office of Investigations.

Management's Response: IRS management agreed that the IRS could use computer programming more effectively to stop refunds on illegal claims for reparations credits. To that end, the permanent implementation and maintenance of a computer program similar to that developed by the TIGTA was approved. In addition, employees from the IRS' Frivolous Returns Program were trained and given access to a new computer Command Code as a potential solution during accelerated returns processing cycles.[2] Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

---

[2] The IRS must process individual refund returns within 45 days of the return due date (April 15 or extension due dates) to avoid paying interest. To minimize interest payments, the IRS accelerates its processing routines during the weeks before the 45-day deadline to ensure returns are timely processed. The IRS saved almost $9 million in interest by accelerating processing in certain weeks of its 2001 Filing Season (i.e., the period from January through mid-April when most individual tax returns are filed).

Table of Contents

Computer Programming Can Be Used to More Effectively Stop Refunds on Illegal Claims for Reparations Credits

Background

Since the early 1990s, thousands of taxpayers have filed specious tax claims with the Internal Revenue Service (IRS) for reparations credits payable to descendants of slaves. The basis of the claims dates back to the post-Civil War period when the Congress supposedly voted for, and President Andrew Johnson vetoed, a bill to provide former slaves 40 acres and a mule as a form of redress for their years in slavery. An article appearing in *Essence* magazine[1] in April 1993 urged descendants of slaves to claim a tax credit on their U.S. Individual Income Tax Return (Form 1040) equal to the current value of 40 acres and a mule. The article estimated that value to be $43,209.

The Internal Revenue Code[2] does not provide for, or allow, such a credit. As a result, the IRS tries to identify tax returns containing these claims, deny the claims, and stop any resulting refunds before they are issued to taxpayers. The vast majority of these claims are manually identified by IRS employees before any data are input to the IRS' computer systems. During Calendar Year (CY) 2001, IRS employees manually identified close to 80,000 such claims. Responsibility for working these claims once they are identified lies mainly with the IRS' Frivolous Return Program.

Because the manual screening of tax returns by IRS employees is subject to human error, and because some employees may knowingly allow these illegal claims to be processed, some claims for reparations credits are processed and refunds sent to taxpayers. Early in CY 2001, the IRS found that this was occurring more often. Many taxpayers claiming reparations credits had received refunds. Some of the refunds exceeded $80,000 for married taxpayers claiming reparations credits for each spouse. As a result, management from the IRS' Frivolous Return Program asked the Treasury Inspector General for Tax Administration (TIGTA) in Ogden, Utah, to help improve their controls by developing a computer program to identify tax returns which were being processed that contained claims for reparations credits. The TIGTA agreed to try and develop

---

[1] Sherrod, L.G. 1993. "Forty Acres and a Mule." *Essence* (April): 26.
[2] Internal Revenue Code, 26 U.S.C. (1994 & Supp. IV 1998).

this computer program and to initiate an audit to review the procedures and criteria the IRS used to identify these claims and stop the associated refunds.

We conducted our audit from April to October 2001 in the Ogden IRS Center. The audit was conducted in accordance with *Government Auditing Standards.* Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

A Computer Program Can Be Used to Identify Tax Returns With Claims for Reparations Credits

Controls designed by the IRS to identify and stop claims for reparations credits from refunding, once the claims were entered into IRS computers, were only partially effective. According to records maintained by the IRS' Frivolous Return Program, the IRS stopped 406 such claims for reparations credits (totaling over $16.4 million) from refunding from February 18 to April 21, 2001. A computer program developed by the TIGTA, applying criteria developed with employees from the IRS' Frivolous Return Program,[3] identified an additional 368 claims for reparations processed during the same time period, that had not been previously stopped by the IRS but could have been using this program (a 91 percent increase). For the remainder of the processing year, the TIGTA computer program aided the IRS in identifying an additional 392 reparations claims totaling over $16.1 million. Employees in the Frivolous Returns Program were able to stop 96 percent of the claims identified by this program.

Controls designed by the IRS rely heavily on manual screening of tax returns by the IRS employees processing the returns. This manual screening is subject to human error. As a result, taxpayers filing the 368 claims during the February to April period referred to above received refunds of over $12.7 million to which they were not legally entitled. In addition, we used the TIGTA computer program

---

[3] Employees from the Frivolous Return Program provided the TIGTA with specific criteria for use in our computer program. We verified their criteria by reviewing random samples of returns which met the criteria to ensure they contained claims for reparations credits and by reviewing random samples of returns which did not meet the criteria to ensure they did not contain such claims.

to analyze a database of tax returns processed for the previous year, Tax Year (TY) 1999, and identified an estimated $18.1 million in reparations claims that were improperly refunded to taxpayers. (All of the returns claiming reparations credits that had not been previously stopped by the IRS were referred to employees in the IRS' Frivolous Return Program, who initiated steps to recover the refunds.)

As part of our review, we worked with the TIGTA Office of Investigations to determine whether IRS employees were making claims for reparations credits or were knowingly honoring claims made by taxpayers. As a result of this effort, we identified one current and eight former IRS employees who claimed reparations credits on their own tax returns. In addition, we identified one employee who may have knowingly honored a claim made by another taxpayer. We referred all pertinent information to the TIGTA Office of Investigations.

Recommendation

1. The Director, Compliance, Small Business/ Self-Employed (SB/SE) Division, should permanently implement and maintain the program developed by the TIGTA. The current program will need minor changes each year for maintenance.

Management's Response: The Director, Compliance, SB/SE Division approved a National Standard Application which will permanently implement and maintain a computer program similar to that developed by the TIGTA.

Use of a Newly-Developed Computer Command Code Can Prevent Claims for Reparations Credits From Refunding During Accelerated Processing Periods

The computer program developed by the TIGTA identifies claims for reparations credits before the claims are recorded on taxpayers' accounts. This normally gives IRS employees time to stop any refunds associated with the claims. However, subsequent to the IRS initiating the use of the TIGTA's computer program, IRS records indicate 16 claims for a reparations credit were refunded to taxpayers.

Employees from the IRS' Frivolous Return Program noted that all but 1 of the 16 refunded claims were processed during the IRS' CY 2001 accelerated processing cycles[4] and that procedures used to stop suspect refunds during other processing cycles were not effective during these accelerated processing periods. However, they had not identified any other procedures to stop the suspect refunds, which totaled over $502,000.

We identified a computer Command Code under development for the IRS' Criminal Investigation function that can be used to prevent suspect refunds from being issued during accelerated processing cycles. Personnel from the Frivolous Return Program were not aware of this Command Code.

Recommendation

2. The Director, Compliance, SB/SE Division, should ensure that appropriate employees from the Frivolous Return Program are given access to and training regarding the computer Command Code under development for the Criminal Investigation function.

Management's Response: Employees from the Frivolous Returns Program were trained on the new computer Command Code and given access to it. Management is

---

[4] The IRS must process individual refund returns within 45 days of the return due date (April 15 or extension due dates) to avoid paying interest. To minimize interest payments, the IRS accelerates its processing routines during the weeks before the 45-day deadline to ensure returns are timely processed. The IRS saved almost $9 million in interest by accelerating processing in certain weeks of its 2001 Filing Season (i.e., the period from January through mid-April when most individual tax returns are filed).

concerned this Command Code will not help prevent direct deposit refunds requested on paper returns. They will continue to work with IRS programmers to prevent this type of erroneous refund.

Detailed Objectives, Scope, and Methodology

Our overall objectives were to:

- Assess whether the Internal Revenue Service (IRS) had sufficient controls in place to identify original and amended tax returns with claims for reparations credits.

- Determine whether a computer program could be used to identify tax returns with these claims.

- Evaluate whether IRS employees were involved in claiming or allowing the claims.

To accomplish our objectives, we:

I.   Identified and evaluated controls over original and amended tax returns to determine whether they were functioning properly to stop erroneous refunds for returns with claims for reparations credits.

   A.   Reviewed the Internal Revenue Manual and local procedures for handling reparation claims.

      1.   Assessed identified controls to determine their effectiveness for stopping refunds that were erroneously released.

      2.   Interviewed IRS employees in the Frivolous Return Program and the Examination function to obtain suggestions for strengthening controls that would stop the refunds from being issued.

   B.   Obtained documentation on reparation claims identified by the Frivolous Return Program that had been refunded to taxpayers, determined what control breakdowns allowed these refunds to be issued, and assessed whether recently implemented control procedures would prevent these from refunding in the future.

   C.   Using the computer program developed in step II, identified refunds, based on reparation claims, issued for Tax Years 1998 and 1999 returns and tax returns processed in the first 30 weeks of Calendar Year 2001.

II. Determined whether tax returns with claims for reparations credits could be effectively computer-identified.

   A.   Developed criteria to identify, during processing, original filed tax returns with the claims.

   B.   Developed additional criteria to identify, during processing, amended tax returns with the claims.

C.   Referred cases identified by the computer in steps II. A and II. B to the Frivolous Return Program so they could be stopped during processing.

D.   Interviewed employees from the Frivolous Return Program to determine which returns identified from the computer runs in steps II. A and II. B would be worked as frivolous returns with reparation claims. Determined what efforts were being made by the Frivolous Return Program to work returns with reparation claims.

E.   Monitored the returns meeting criteria developed with employees from the Frivolous Return Program to determine:

    1.   The amount of the claim.

    2.   The date the claim was processed.

    3.   The IRS Submission Processing Center through which the claim was processed.

    4.   Whether the claim was identified as erroneous prior to its identification by our computer runs; how it was identified; and the IRS Functional Program area that identified it.

    5.   If the claim resulted in a refund.

F.   Selected a random sample of 39 returns identified from the Treasury Inspector General for Tax Administration (TIGTA) computer run meeting criteria developed in conjunction with the IRS' Frivolous Return Program as being possible reparation claims. Obtained the tax returns (or other source documents) to determine whether the taxpayers actually claimed a reparation credit on their returns. There were 212 returns processed between April 12 and June 30, 2001, that had credits that met the criteria. Our sample of 39 returns was based on a 95 percent confidence level, an estimated error rate of 5 percent, and a precision of +/- 6.2 percent.

G.   Selected a random sample of 15 returns identified from the TIGTA computer run that had claims on line 64 of U.S. Individual Income Tax Return (Form 1040) but did not match the other criteria developed with the Frivolous Return Program as a possible reparation claim. Obtained the tax returns (or other source documents) to confirm that the returns did not contain a reparation claim. There were 515 returns processed between April 12 to June 30, 2001, that had an entry on line 64 but did not meet the other criteria. Our sample of 15 was based on a 95 percent confidence level, an estimated error rate of 1 percent, and a precision of +/- 5 percent.

H.   Selected the amended returns that met the dollar and other criteria used by the Frivolous Return Program and ordered the tax returns (or other source documents) to determine whether the cases were actually claims for reparations credits.

III.   Evaluated the extent to which IRS employees were involved in claiming or allowing claims for reparations credits.

A. Referred the database of taxpayers making reparation claims that we obtained from step I.C to the TIGTA Office of Investigations.

B. Referred one amended return to the TIGTA Office of Investigations that was identified from step I.C as containing a reparation claim. The TIGTA Office of Investigations will analyze the processing of this return to determine if the employee was sympathetic to the taxpayer.

Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Richard J. Dagliolo, Director
Kyle R. Andersen, Audit Manager
L. Jeff Anderson, Senior Auditor
Bill R. Russell, Senior Auditor
Greg A. Schmidt, Senior Auditor
Annette B. Hodson, Auditor
James E. Adkisson, Computer Specialist
Layne D. Powell, Computer Specialist

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Compliance Services, Ogden S:C:CS:O
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison:
      Commissioner, Small Business/Self-Employed Division S:COM

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $90,731,930 in frivolous claims stopped (see page 2).

Methodology Used to Measure the Reported Benefit:

Identification of Population -

The Treasury Inspector General for Tax Administration (TIGTA) Information Technology staff computer-identified reparation claims on tax returns that posted to the Internal Revenue Service (IRS) Masterfile[1] for Tax Years (TY) 1998 and 1999 and tax returns processed in the first 30 weeks of Calendar Year (CY) 2001. The criteria identified all U.S. Individual Income Tax Returns (Form 1040) and amendments made to Forms 1040 claiming credit amounts over a specified threshold (and indicative of typical reparation claims) on line 64. The TIGTA program identified 30,392 records for that period with credit amounts over that threshold. There were 1,184 returns[2] that had line 64 amounts indicative of reparation claims totaling over $35.5 million that had refunded to taxpayers and the IRS had not stopped the refund or recovered and reversed the refunds.

Sample Results -

The criteria used to identify the 1,184 returns were verified using a statistical sample of 39 returns from a population of 212 returns processed between April 12 and June 30, 2001 (estimated error rate of 5 percent, confidence level of 95 percent, precision of +/- 6.2 percent). Thirty-seven of the 39 (95 percent) were confirmed reparation claims. Accordingly, we demonstrated that the TIGTA program was more effective than manual methods of identifying reparation claims.

---

[1] The Masterfile is the IRS' computer system that stores various types of taxpayer account information.

[2] The 1,184 returns identified by the TIGTA program as reparations claims included 269 returns from TY 1998, 606 returns from TY 1999, and 309 returns for the first 30 weeks of CY 2001. The numbers reflect only returns for which the IRS had not been able to stop refunds before they were issued, or subsequently recover the refunds.

Projection of Results -

$90,731,930 – Frivolous claims will be stopped from refunding to taxpayers – The computer run identified 606 tax returns that were refunded reparation credits worth $19,101,459 for TY 1999. Taking 95 percent of these amounts (to reflect the results of our sample) gave a projected 576 returns with refunded reparations credits totaling $18,146,386 for TY 1999. These values will be used to project the amount of tax savings over the next 5 years. TY 1999 is being used in our projections since these returns were generally processed in CY 2000, the most recent full year of data available. The number of claims released to taxpayers in CY 2001 was substantially reduced by the implementation of the TIGTA program. We estimate that the program implemented by the TIGTA will stop at least another 2,880 (576 returns times 5 years) frivolous reparation claims worth almost $91 million ($18,146,386 times 5 years) over this 5-year period. This is a conservative estimate due to the fact there is no built-in increase in volume or dollar amounts for this 5-year period. In comparison, there was a 201 percent increase in the number of claims filed and a 36.5 percent increase in the average amount per claim from TY 1998 to TY 1999.

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED

MAR 2 2 2002

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

MAR 1 9 2002

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

From: Joseph G. Kehoe
               Commissioner, Small Business/Self-Employed Division

Subject: Treasury Inspector General for Tax Administration (TIGTA) Draft
               Report - Computer Programming Can be Used to More
               Effectively Stop Refunds on Illegal Claims for Reparations
               Credits (Audit No. 200130028)

We reviewed your report and agree we can use computer programming more effectively
to stop refunds on illegal claims for reparations credits.

We also believe we should identify and process frivolous filings as quickly as possible to
prevent further occurrences. To this end, we made significant investments in training
employees who identify frivolous filings. We also worked with the TIGTA to implement a
data extract process that identifies illegal reparations claims before they post to the
masterfile. This process should allow us to realize the outcome measure for the
potential revenue protection as stated in your report.

While we agree we can make improvements, we feel additional actions must be taken
to solve our current system limitations. Your recommendations are discussed in detail
below.

IDENTITY OF RECOMMENDATION: 1
The Director, Compliance, Small Business/Self-Employed (SB/SE) Division, should
permanently implement and maintain the program developed by the TIGTA. The
current program will need minor changes each year for maintenance.

ASSESSMENT OF CAUSE (S)
We did not effectively identify reparations claims during processing. As a result, we
paid some erroneous refunds.

CORRECTIVE ACTIONS
We approved a National Standard Application (NSA), which will permanently implement
and maintain a program similar to that developed by the TIGTA. In addition to
identifying illegal reparations claims, our program includes enhanced ability to extract
data on other types of frivolous filings. It is scheduled to begin running on March 8,
2002.

2

Beginning March 15, 2002, we will receive weekly extracts that we will compare with those provided by the TIGTA to ensure the program is accurately identifying the appropriate data. Based on the extract data, we will determine whether this process fully corrects the problem.

IMPLEMENTATION DATE
PROPOSED: March 8, 2002

RESPONSIBLE OFFICIAL (S)
Director, Compliance, SB/SE Division

CORRECTIVE ACTION (S) MONITORING PLAN
The Program Manager for Service Center Compliance, within Compliance Policy, will update SB/SE management concerning any delay, change or problem with the implementation.

IDENTITY OF RECOMMENDATION 2
The Director, Compliance, SB/SE Division, should ensure that appropriate employees from the Frivolous Return Program (FRP) are given access to training regarding the computer Command Code under development for the Criminal Investigation function.

ASSESSMENT OF CAUSE (S)
The TIGTA identified a computer Command Code (NOREF "P") our Criminal Investigation function is developing that we could use to prevent suspect refunds from being issued during accelerated processing cycles. Frivolous Return Program personnel were not aware of this Command Code.

CORRECTIVE ACTIONS
We trained FRP employees on the new Command Code NOREF "P" and gave them access to it. We implemented the new command code as a potential solution during accelerated processing cycles. However, we are concerned it will not help us prevent frivolous filings on paper returns refunded through direct deposit. We will continue to work with our programmers to prevent this type of erroneous refund.

We also continue to train employees whose responsibilities include identifying frivolous filings. In addition, we asked for a Chief Counsel opinion to allow us to recover erroneous refunds from banks.

IMPLEMENTATION DATE
This training was completed February 27, 2002. The work with the programmers is ongoing. We expect Chief Counsel's Opinion by December 31, 2002.

RESPONSIBLE OFFICIAL
Director, Compliance Services, Ogden Compliance Service Center

3

<u>CORRECTIVE ACTION (S) MONITORING PLAN</u>
The Program Manager for Service Center Compliance, within Compliance Policy, will monitor and update SB/SE management concerning any delay, change, or problem with the implementation.

If you have any questions, please call Martha Sullivan, Director, Compliance, SB/SE Division, at (202) 283-2144.